THE RICHEBÄCHER LETTER

Monthly Analysis of Currencies and Credit Markets

Number 280 **August 1996**

Good Points

Crash in the Making

> **"Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes a bubble on a whirlpool of speculation. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done."**
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> **The General Theory of Employment, Money and Interest**
> **John Maynard Keynes, 1936**

The bullish wave has crested on Wall Street, and now threatens to come crashing down on the hordes of analysts and investors who bet so heavily – and so foolishly – on their dreams of a perpetual stock-market boom.

The bear market has only just begun, yet already the carnage has been fearful. Declines of 50% or more have ravaged the once high-flying technology sector, ending one of the most extreme speculative manias of the entire bull market. While the major indexes have suffered less severe losses to date, their inability to mount more than the feeblest of rallies suggests further declines are in store.

In this issue, we examine the source of the market's distress. It can be found in the fundamentals, specifically, in the deteriorating outlook for U.S. corporate earnings. Reality, so long denied by the bulls, can no longer be avoided. A string of disappointing earnings reports have exploded the myth of a secular improvement in business profits, made possible by ruthless corporate cost cutting and restructuring.

We expose the U.S. profits "miracle" of the 1990s for what it truly was: a temporary windfall generated by the sharp decline in long-term and short-term interest rates, which slashed corporate net-interest expenses. Credit for this earnings bonanza rightly should go not to corporate management, but rather to the monetary laxity of Mr. Greenspan and the Federal Reserve.

The roots of the coming debacle have been obvious for some time – obvious, that is, to anyone with an elementary grasp of economics. As we have pointed out repeatedly in recent letters, revisions to the Commerce Department's official statistics have utterly erased any evidence of a secular recovery in U.S. productivity growth – the essential ingredient to any sustainable improvement in living standards and corporate profits.

With average annual productivity gains still mired below 1%, it was only a matter of time before Wall Street's profits euphoria came to a brutal end. In that sense, the market has been resting on air since at least 1994, when the windfall earnings growth fueled by declining interest rates abruptly slowed.

Why has the day of reckoning been so long delayed? Bullish propaganda and speculative enthusiasm provide only a partial answer. Corporate management has contributed in its own way – through massive share buybacks and merger deals that have drastically reduced the supply of stock outstanding. For much of the past two years, relatively sluggish earnings growth has been hidden behind a facade of impressive gains in per-share earnings, the inevitable consequence of the steady reduction in outstanding shares.

We can only tremble to think of the damage that a bear market on Wall Street will inflict on other global markets, and on the already unstable dollar.

FALSE PROFITS

It long has been the great, intriguing question: What ultimately might burst the U.S. stock market bubble? Wall Street's sudden plunge definitely has answered this query. The obvious catalyst of the dramatic change in market sentiment has been a string of disastrous profits reports from the formerly high-flying technology sector. This has prompted worries that the U.S. corporate earnings boom may have reached a sudden, unexpected end. Recent reports of a sharp drop in stock mutual fund sales may strike the final blow.

This leaves us, however, with a pertinent, new question: Does the recent weakness and associated volatility of the financial markets represent a short-term blip, the start of a temporary decline – generally called a correction – or a fundamental shift to a prolonged bear market for equities, if not an outright crash?

In trying to make a reasonable guess at the answer to this question, one issue seems of overriding importance, namely, the future trend in corporate profits. To be sure, since 1992 the U.S. stock market has enjoyed massive support from an unprecedented, broad surge in total profits, averaging about a 50% increase.

Yet market valuations, as measured by the various stock indexes, have outpaced earnings by a sizable margin. The Dow Jones Industrial Average has gained 72%, the S&P 500 66% and the Nasdaq an astonishing 125% over the past four years. In other words, investors have been willing to pay ever higher prices for a given stream of corporate earnings.

IS THERE VALUE IN U.S. STOCKS?

Basically, stock prices are driven by two variables. One is changes in corporate profits, the other changes in the market valuation of those profits. Since the current boom started in the early 1980s, investors have been handsomely rewarded by both factors. Clearly, the key issue is whether the same two levers will generate further strong gains in stock prices. Will they, can they deliver? Our answer, as we shall explain, is a strict no.

Wall Street's steady incantation has been that this profit boom is not just a temporary trend but of a secular, lasting nature. This view fits in nicely with the general perception of "lean and mean" U.S. corporations that are boosting profits and shareholder values through a savage reductions in costs, particularly labor costs. In this view, the profits miracle fueling Wall Street's boom is a long-run phenomenon.

Earlier, we said that investors during the 1990s have paid ever higher prices for corporate profits as stock prices outgained earnings gains. Oddly, however, the price-earnings ratios that actually measure earnings per share have rather magically declined during the same period. For the S&P 500 stocks, the average ratio has fallen from 68 in 1992 to 20 currently, and for Dow stocks it has dropped from 25 to 18.

How does such arithmetic magic come about? Very simple: through big stock buy backs and debt-financed merger and takeover deals, which together have led to huge withdrawals of outstanding corporate stock. As the number of outstanding shares shrinks, profits per share essentially increase, which has the effect of lowering the price-earnings ratio. Citicorp, to name one example, has spent $1.5 billion this year buying its own stock, producing a profit rise of 18% per share, as against an actual earnings advance of only 12%.

Or take Coca Cola, a stock that epitomizes the current stock-market bubble. Coke is widely recommended as a defensive play, even though its price-earnings ratio of 36 is manipulated to the down side. We say manipulated because profits-per-share persistently are dressed up by heavy company stock buy backs. Last year, the company spent $1.8 billion in this fashion, following a $1.2 billion expenditure in 1994. The result has been to transform mediocre revenue growth of 6.4% into a more inspiring double-digit gain of 16.7% per share.

Having done some thinking about the broad economic and financial effects of these operations and the associated bullish market responses, we must say that we are quite horrified. It really exhibits the "shareholder

Global Capital Market Trends

Equities

Selected Markets, % Change

Country (July 26)	Month	YTD	Y-Y	Vs. 12-Mo Hi	Vs. 12-Mo Lo
Australia	-4.9%	-2.7%	0.4%	-7.9%	4.2%
Canada	-1.9%	4.7%	7.2%	-6.0%	14.4%
France	-7.1%	4.9%	1.0%	-8.6%	14.0%
Germany	-4.2%	9.6%	10.2%	-4.4%	17.9%
Hong Kong	-3.2%	6.3%	14.4%	-7.7%	20.3%
Japan	-6.8%	6.3%	28.9%	-6.8%	29.1%
Mexico	-5.9%	7.6%	25.7%	-10.8%	36.7%
Spain	-6.9%	9.2%	17.9%	-7.3%	24.3%
U.K.	-0.6%	-0.4%	6.3%	-4.8%	6.7%
U.S.	-4.3%	3.2%	13.2%	-6.3%	14.6%

Ten-Year Bond Yields

Selected Markets, Basis Point Change

Country (July 26)	Current Rate(%)	Month	YTD	Y-Y	Vs. 12-Mo Hi	Vs. 12-Mo Lo
Australia	8.45	-47	18	-84	-97	48
Canada	7.57	-21	49	-70	-90	63
France	6.40	-17	-23	-95	-121	13
Germany	6.37	-19	34	-38	-44	57
Japan	3.31	0	24	30	-23	54
Spain	8.87	-1	-83	-223	-248	25
U.K.	7.87	-9	45	-29	-38	63
U.S.	6.85	-4	128	45	-21	133

Exchange Rates

Versus U.S. Dollar, % Change

Country (July 26)	Current Rate	Month	YTD	Y-Y	Vs. 12-Mo Hi	Vs. 12-Mo Lo
Australia ($)	1.27	-0.5%	5.6%	6.3%	-2.0%	7.1%
Canada ($)	1.38	-1.1%	-0.7%	-1.2%	-3.4%	0.7%
France (*f*)	5.03	2.5%	-2.4%	-4.5%	-5.7%	3.9%
Germany (DM)	1.48	3.0%	-3.0%	-6.8%	-7.6%	4.2%
Japan (¥)	108.3	1.1%	-4.7%	-23.2%	-23.2%	2.3%
Spain (Pt)	126.2	1.6%	-3.7%	-5.8%	-6.8%	2.6%
U.K. (£)	1.56	0.1%	-2.4%	-2.2%	-3.3%	4.2%

economy" in all its perversity. We can only remark that the goal of this corporate share-buying exercise appears to be to push share prices higher by all possible means, with little or no regard for the associated economic and financial ill effects. By far the biggest distorting influence both on market forces and on the profits picture clearly has been the merger-and-acquisitions binge, recently running at an annual rate of several hundred billion dollars.

From the standpoint of the financial interests of the corporations involved, it is absolutely silly to amortize equity capital, which, thanks to elevated market valuations, is so cheap. In a normal world, such high price-earnings ratios would act as an incentive for companies to *raise* equity capital, not dissipate it.

But the interest of management, ~~being paid to~~ a ~~large~~ extent through stock options, is exactly ~~the~~ opposite. Above all else, ~~it wants rapidly~~ rising stock prices. At bottom, this is deliberate manipulation in order to delude the investing public about corporate earnings power.

The most absurd aspect of all is the fact that a large part of the merger and takeover binge – running recently at an annual rate of several hundred billion dollars – has been paid for with cash or debt, not through an exchange of shares. By paying heavy premiums over current stock prices, the acquiring corporations inherently disperse their equity capital to the shareholders of the target company, while their own shareholders at best break even.

Strictly speaking, these transactions are at the expense of the acquiring shareholders. But what seems to motive them is a common desire to get on with the party, in hopes that next time they themselves will be among the lucky bought-out target shareholders. All too clearly, merger mania has been the key force driving the bull market.

In assessing these huge corporate stock purchases, it must be realized that they exert multiple leverage effects on the markets. First, they raise share prices directly. Second, they reduce the supply of outstanding stock. Third, they put corresponding amounts of money into investors' pockets, which largely is reinvested. Fourth, they increase earnings per share, as already described.

Undeniably, the merger craze is good for shareholders, who profit from extraordinary gains in stock prices. But it should be just as clear that in the long run, shareholders – like everybody else – will fare well only if this financial engineering also is good for the economy as a whole. Indeed, for years mergers and takeovers were lauded for the efficiency gains they allegedly brought to both acquired and acquiring companies, enhancing overall productivity and GDP growth.

WHAT REALLY MADE THE PROFITS BOOM?

At first glance, this optimistic assessment would seem to be borne out by a spectacular rise in U.S. business profits, particularly since 1992. To be sure, these profit gains are unequaled, and are reflected in an unequaled stock-market boom. But precisely because of this causal relationship, it becomes all-important to discern the precise sources of super-profits seen during this period. Are they transient or long lasting? That is the cardinal question at this point. The answer holds far-reaching implications for future stock prices.

Considering that share prices rose even faster than earnings over the past four years, one must conclude that the markets have been counting on a continuation of such a stellar profits performance. Yet hardly anyone has bothered to investigate the matter. To our knowledge, only an analyst at Goldman Sachs has taken a closer look. His findings are laid out in a recent research report: "Profit and Labor: The Pendulum at Rest."

His study ends with the comforting conclusion that the recent U.S. earnings boom reflects chiefly a lasting recovery in the profits share of national income, relative to the wage share, from the extremely depressed levels of the early 1980s. He also argues that this shift in income shares is not due for a reversal. In short, the strong profit performance of recent years has a secular character, and has brought relative income shares back toward the more "normal" proportions of the 1960s.

This explanation surely is to Wall Street's liking. It apparently confirms the propaganda mantra that higher profits mirror both greater efficiency and the squeezing of costs. Wanting to form our own opinion, we have taken a closer look at the U.S. corporate profits performance. But we have reached very different findings, ones that actually bode ill for future profits and consequently for future stock prices.

PROFIT EXPLOSION THROUGH NET INTEREST IMPLOSION

Beginning in 1992, corporate earnings went on a four-year binge, rising 19% a year on average. This was extremely unusual. The profits explosion indeed sprang chiefly from a sudden, pronounced shift in income shares. But this occurred predominately between corporate creditors and corporate shareholders – in other words, between loan capital and equity capital.

The largest single cost saving by corporations during 1990-95 was in interest expense, as the extraordinary rise in corporate profits from 7.7% to 10.3% of the GDP of nonfinancial corporations squared with a decline in corporate net-~~interest payments from 4.9% to 2.6% of GDP.~~

In other words, falling interest expense accounted for no less than 88% of the corporate sector's registered profits gains during the years in question. Despite a rapid rise of corporate debt and a drastic deterioration in the debt-to-equity ratio, corporate net-interest payments plummeted from $148 billion to $101 billion.

On the surface, the U.S. stock market boom of the 1990s was earnings driven, which normally ranks as a healthy source of support. But the salient point to see here is that the amazing surge in corporate earnings during these years largely reflected a transient, windfall gain from the exceptional fall in interest rates.

What's more, the prolonged, steep decline in rates acted as a double whammy on stock prices: On the one hand, it was an important marginal cost factor; on the other, it lowered the capitalization rate for all asset values, including stocks.

For understandable reasons, Wall Street bulls prefer to explain the stock market boom as the result of cost cutting by corporate management. This suggests increasing efficiency. Accordingly, for years Wall Street's resounding bull story has been that the surge in profits was the manifestation of a tremendous acceleration in U.S. productivity growth. But that story was crushed only a few months ago by the GDP benchmark revisions released by the Commerce Department, which swept the supposed productivity miracle out of the statistics.

Income Shares of U.S. GDP of Nonfinancial Corporations

Totals in Billions of Dollars

	1982		1985		1990		1995	
	$ Total	% GDP	$ Total	% GDP	$ Total	% GDP	$ Total	% GDP
Corporate GDP	$1,568.7	100%	$2,267.1	100%	$3,008.9	100%	$3,875.6	100%
Wages and Benefits	$1,198.1	76.3%	$1,489.8	65.7%	$2,023.3	67.2%	$2,564.7	66.2%
Capital Consumption	$209.7	13.4%	$252.6	11.1%	$327.3	10.9%	$424.0	10.9%
Net Interest	$72.3	4.6%	$81.1	3.6%	$148.5	4.9%	$101.4	2.6%
Profits	$118.1	7.5%	$170.2	7.5%	$232.5	7.7%	$403.0	10.3%

Source: Commerce Department

If there has been a general turn to slash-and-burn management, it has in any case failed miserably to improve labor productivity, which since the early 1970s has remained stuck at an average annual growth rate of only 0.7%, the lowest rate of any industrialized country. It is not corporate management who have orchestrated the profit and stock market explosions, but rather Federal Reserve chairman Alan Greenspan.

In order to comprehend the looming profit difficulties of the U.S. economy, it is helpful to review the productivity and wage trends since 1992. Over the past three-and-a-half years, total output has registered a formidable cumulative rise of 12%. Given that labor productivity rose just 3% overall during that period, it seems safe to say this growth was highly labor intensive.

But now comes the crux of the matter: During the same three-and-a-half years, hourly compensation rose 11% – far in excess of the low productivity gains. As a result, unit labor costs rose 8%. Owing to rising inflation, however, real earnings per hour virtually stagnated.

Relative to the miserable trend in productivity growth, wage rises have been much too high. But relative to current inflation, they are much too low. That's the central dilemma plaguing the U.S. economy. The underlying key problem, of course, is the absence of productivity growth. In conjunction with low savings, this makes the U.S. economy particularly prone to inflation. Chronic inflation rates of around 3% provoke corresponding wage demands, which are too low to significantly improve living standards but too high compared to the feeble productivity trend. It's a perfect vicious circle.

TWO FOREBODING MESSAGES

All together, the data convey two foreboding messages:

- The U.S. corporate profits boom of 1992-94 had its main source in the interest-rate collapse. That effect was transitory, not permanent. The one-time bonus for corporate finance spent itself in 1994, implying considerably lower profit growth in the future.

- The persistent divergence between poor long-term productivity growth of less than 1% and rises in hourly compensation of 3-4% implies that business profits in the United States now depend crucially on consumer inflation continuing at an annual rate of about 3%. As an aside: An annual clip of 3% inflation cuts the value of $1 to 50 cents in just 23 years.

It goes without saying that the sharp flattening of profit growth will act as a big negative for the U.S. stock market. In actual fact, reported profits nosedived last year after four years in a row of double-digit gains. The February 20 edition of *The Wall Street Journal* presented a tabulation showing that the net income of 692 large

companies in fourth-quarter 1995 declined 18% from the year-earlier level, compared to a rise of 5% in the third quarter and a eye-popping 61% increase in fourth quarter 1994. Profits in the technology sector, by the way, were down 58%.

Admittedly, reported earnings have been distorted by the many one-time charges connected to the restructuring wave. But these have long since become a regular feature of U.S. corporate accounting. Operating profits in the non-financial sector, as calculated in the GDP accounts, increased only 4.4% in 1995, also a far cry from their 21% rise in 1994. Yet stock prices jumped in the course of 1995 by no less than 35% for the Dow, 34% for the S&P 500 and 41% for the Nasdaq index.

In other words, while stock prices soared as never before, the handwriting was already clearly on the wall: profit growth had dramatically slowed. Yet the supposedly vigilant markets completely ignored this warning. How was that possible? It's really very simple.

The Tech Stock Slaughter

Company	52-Wk Hi	Current	% Decline
Iomega	55.13	17.63	-68.03%
America	71.00	27.13	-61.80%
Presstek	200.00	48.00	-76.00%
Zolteck	47.25	24.75	-47.62%
Hewlett	57.69	43.75	-24.16%
Wang	26.13	17.38	-33.49%
Micron	94.75	18.00	-81.00%
US	105.50	54.52	-48.33%
Altera	77.00	35.13	-54.38%
Applied	59.88	22.82	-61.90%
Cirrus Logic	61.13	15.00	-75.46%
Atmel	42.38	25.38	-40.12%
Xilinx	55.50	29.00	-47.75%
Motorola	82.50	53.00	-35.76%
Apple	47.50	21.00	-55.79%
Digital	76.50	34.13	-55.39%
Autodesk	53.00	23.13	-56.37%
3Com	53.63	37.63	-29.84%

Wall Street applied a trick. When alerted by the companies that forthcoming earnings would be below forecasted levels, analysts promptly cut their original high profit expectations – in essence, lowering the bar for companies to achieve the all-important "met or exceeded analysts expectations." What would have appeared bad news in the light of earlier high estimates was perceived as positive.

Since earnings are typically measured against the whittled-down late estimates, numerous profits earnings reports in this way were magically transformed into "better than expected" earnings, a perception that tends to boost stock prices.

A recent, almost scandalous example of this shell game is IBM. On July 25, the company reported profits of $2.51 per share. This was 5 cents, or 0.20%, better than expected earnings of $2.46 per share. Despite some disquieting disclosures, commentators fell over each other to hail the report as evidence that the situation in the high-tech sector is better than had been thought. Soaring by 13.4% that day, IBM stock led a market rally.

In reality, it was a disguised profits disaster. Against a year ago, overall net earnings plummeted 21.6%, from $1.71 billion to $1.34 billion. Profits per share, owing to stock repurchases, declined by a much smaller 14.5%, from $2.97 to $2.51. Either way, it was pretty negative. But this actual sharp decline in profits was positively dressed up through comparison with the latest low profit estimate of $2.46 per share. Nobody remembered or cared to mention that this low, late estimate was but a shadow of an original estimate of $3.25, which was slashed over the course of a three-month period by 81 cents.

For more than a year, Wall Street has been in total denial of the sharply deteriorating profits picture. With or without malign intent, it systematically has misinformed the public. Corporate management has been a willing participant in this misinformation game, judging by a number of recent press reports that highlight the various distortions and half-truths used by companies to pad out reported earnings.

Well, this game worked splendidly in 1995 but less and less well in 1996, least of all in the high-flying technology sector, where a rising tide of disastrous profits reports has made it impossible to deceive the public any longer. Many high-tech stocks have experienced a virtual free fall.

Earlier, we explained why we see such a general, drastic deterioration in U.S. corporate profits. But within this overall trend, the tech sector is a particularly woeful case. It suffers from the double blow of a dramatic slowdown in sales, and a worldwide explosion of production capabilities geared to the fabulous growth rates of demand seen in recent years.

After soaring to record heights throughout May and into early June, the tech-heavy Nasdaq index finally has succumbed to the weight of the flood of negative earnings preannouncements and the scores of analysts lowering their earnings estimates. Yet even now, many bulls have not given up on their established practice of buying on the dips.

GREETINGS FROM INFLATION

In his recent Humphrey-Hawkins testimony to Congress, Mr. Greenspan stressed the Fed's intention to raise interest rates if its sees evidence of strain in the economy. In reality, signs of excessive monetary looseness already are everywhere: in the burgeoning trade deficit fueled by surging imports, the merger and mutual-fund manias, the extremely low unemployment rate, accelerating wages and prices, domestic demand growth well in excess of potential growth, and the chronically weak dollar, to name just a few.

These are all classic hallmarks of extremely loose money and associated excesses. It is the traditional, cardinal error of the Fed and of most American economists to focus their inflation watch exclusively on consumer and producer prices. Monetary inflation can express itself in many different ways, other than through the conventional prices indexes. The main, alternative outlets are rising asset prices and a worsening trade deficit.

In this respect, it is clear the disastrous lessons of the U.S. stock-market boom and bust of the late 1920s and the Japanese bubble of the late 1980s have not been learned either by the Fed or on Wall Street. It is important to remember that both cases of roaring asset-price inflation occurred in the face of zero consumer and producer price inflation.

In fact, if not for the massive diversion of excess domestic demand to the rest of the world via the huge trade deficit, U.S. consumer inflation already would be running at an intolerable annual rate of 4-5%, forcing the Fed to tighten. But for the extended support operations of foreign central banks, the dollar long since would have collapsed.

A central bank truly vigilant against inflation long ago would have acted to contain the proliferating excesses and imbalances within the U.S. economy, its financial system and asset markets. Instead, Mr. Greenspan had only good things to say in his testimony. Though conceding that consumer inflation might end 1996 running at a 3-to-3.25% rate, he instantly played down that forecast by remarking that more moderate economic growth in the second half of this year almost certainly will slow inflation in 1997.

We find it interesting that at this particular moment, with inflation pressures mounting and tightening fears spreading in the markets, the press has been able to obtain an internal Federal Reserve study arguing for a policy of "opportunistic disinflation." In essence, this term implies that Fed policymakers should allow small inflation shocks to feed through into prices because to fight them would exact too great a price in terms of lost output and declining asset prices. We would say this label exactly describes current Fed policy.

If the U.S. economy fundamentally is as strong as recent GDP reports suggest, the Fed's striking reluctance to consider even a symbolic mini-rate hike is hard to understand. We think true reason for Mr. Greenspan's hesitation is his fear that even a tiny tightening move would puncture the increasingly fragile financial bubble. Yet he ought to be aware of the painful historical experience: The longer and bigger a speculative bubble is allowed to expand, the worse the later, inevitable crash.

FALSE COMFORT

Many bulls take comfort from the prevalent perception that in the absence of rising inflation and any monetary tightening, a serious setback in the financial markets is well-nigh impossible. Even Mr. Greenspan, who should know better, seems to be a true believer, given his stubborn monetary abstinence.

We think this comforting market view is misplaced. Any overspending, whether on consumption, investment goods, or financial assets, simply cannot last forever. There is bound to come a critical point where balance sheets and liquidity become so overextended that they compel a retrenchment. Luckily, rising inflation usually tends to force central banks into action before this happens.

The harrowing fact, conveniently overlooked, is that the worst financial crashes in history – the ones that had the most devastating effect on real economies – took place in the total absence of price inflation. Far from preventing calamity, the absence of inflation contributed to both the 1929 U.S. stock market crash and the 1989-90 Japanese stock and land collapse, by misleading central banks into keeping money too loose for too long.

When the Bank of Japan finally began to raise its discount rate in 1989, its concern was not with the consumer price index but with puncturing the financial bubble before it burst of its own accord from even more extreme levels of overvaluation, wreaking havoc in the overleveraged Japanese banking system. But it was already too late.

The U.S. experience in 1929 was even more catastrophic – and the Fed's negligence even greater. It is true that the New York Fed did raise its discount rate before the October crash, from 5% to 6% in early August. But this was purely a symbolic move. For the markets, the really important action was a simultaneous cut in the buying rate for prime bankers' acceptances – at that time the Fed's primary money-market rate. This was lowered to 5⅛% from 5¼%. Though a minuscule move, it served to pull the Fed rate down to the prevailing call-money rate, leading to a sharp increase in the Fed's purchases of acceptances. This fueled a sizable jump in bank reserves, with the result that the call rate for broker loans dropped from 9.6% on August 10 to 6.2% prior to the crash. When Black Monday arrived, this rate was at its lowest level in years.

What ultimately triggered the Great Crash was not monetary tightening but the hurried unwinding of massive financial leverage. This is bound to happen sooner or later in the course of any asset bubble, irrespective of a central bank's monetary stance.

BEARISH DIFFERENCES

The bears have taken over in the global stock markets, and as usual, Wall Street plays the bellwether. Yet we notice tremendous differences both in the reasoning and expectations of the various bear camps. The great majority of analysts clings desperately to the belief (hope?) that the U.S. stock market's recent wild gyrations represent just a passing correction in a continuing bull run. The most enthusiastic bulls by no means have capitulated. Their new gospel is to pick stocks that will best weather the correction. Apparently, cash remains trash in their eyes.

Only a small minority of analysts, though perhaps growing, is truly bearish, warning of a severe setback or even a full-fledged bear market. Yet there are two extremely different scripts for this drama.

The predominant bear case argues that the U.S. economy will keep thundering ahead, growing above its potential rate with a resulting increase in inflationary pressures. This will compel the Fed to launch a series of tightening moves. As frenzied speculation has made the financial markets highly vulnerable, the resulting market correction will be even larger than expected by the consensus crowd, which still hopes that a weakening of the economy in the second half of this year will forestall a major round of rate hikes.

We hesitate to call this scenario a "full-fledged" bear case. Basically, it conforms with the consensus view that the U.S. economy is in good shape and without any dangerous imbalances. The main difference lies in the timing

of the end of the business cycle. The consensus view, which expects a small correction, is that the economic expansion is peaking of its own accord, while the minority view still sees so much economic strength that a heavy foot on the brake by the Fed will be needed to tame it.

In our view, the problems of the U.S. economy and its financial system go a lot deeper than just temporary cyclical strains. Both the economy and the markets are far more imbalanced and vulnerable than generally is realized. A consumer borrowing binge that exceeds current income growth, like the one underway since 1991, may help produce GDP growth and rampant wealth effects – of a sort. But it rests on loose money and borrowed time.

Any beginner in economics ought to know that such a stampede into debt for consumption is neither desirable or sustainable. During the first quarter of 1996, real U.S. consumption growth of $44 billion *exceeded* real U.S. GDP growth of $39 billion. No wonder the trade deficit exploded! That's what the old economists used to decry as a structural distortion.

THE ESSENCE OF INFLATION – STRUCTURAL DISTORTIONS

Unfortunately, the bias toward debt-financed overconsumption has been exerting its deforming effects on the entire warp and woof of the U.S. economy for many years now. This brings us to a key postulate of Austrian credit theory – an intellectual tradition largely misunderstood or ignored in the Anglo-Saxon countries. The essence of inflation is that it kindles speculation and distorts demand. This, in turn, leads to corresponding distortions in the investment and output structure.

In Japan, the debt bubble of the late 1980s stoked rampant speculation in real estate and stocks, with a corresponding effect on the GDP of massive overinvestment in commercial buildings and industrial plant. In America, debt also has fueled rampant financial speculation, but with overconsumption as its main GDP counterpart. Capital and credit have been directed excessively toward retailing and service businesses – the types of firms that hire low-wage workers. This in itself has set up a powerful feedback effect, since low-wage workers must borrow heavily to maintain the middle-class lifestyle to which most Americans have become accustomed.

Rampant growth in debt-financed consumer spending has been matched by whopping overinvestment – or more correctly, malinvestment – in consumer goods and services distribution. Given these verifiable facts, we are forced to conclude that anybody who says U.S. economic growth is well-balanced really doesn't understand economics.

Again, the main villain in this regard is Wall Street. It not only provides the hype that supports inflated stock prices (and thus the balance sheets of American consumers), but even more importantly it securitizes and sells most of the newly created consumer debt, in the form of asset-backed securities. This is true for mortgages (Fannie Mae and Freddie Mac), second mortgages (The Money Store, UCF Financial), mobile-home mortgages (Green Tree Financial), student loans (Sallie Mae), credit cards (Advanta, First USA, MBNA, Household International and some banks), and even poor-quality auto loans (Credit Acceptance, Americredit, Mercury Finance, Olympic Financial, and so on).

Clearly, much of the surprising strength in the U.S. economy is related to the incredibly easy credit provided by these financial "growth" companies. But once the economy and the markets seriously weaken, hidden problems will surface with a vengeance. We wouldn't be at all astonished to learn one day that a lot of this paper has been financed by the same speculative carry-trade players who have played such a crucial role in propping up the U.S. Treasury market. Truly, the U.S. economy is tied to the well-being of Wall Street as never before – even more than in 1929.

THE Q FACTOR

Earlier, we pointed to one of the more insane aspects of the current merger-and-takeover mania, which is that the acquiring companies squander their capital in favor of the target shareholders. This fact has received some publicity in connection with the so-called Q ratio, developed by the American economist James Tobin.

The Q ratio measures the market capitalization of companies relative to the replacement cost of their existing stock of capital. Or, to put it differently, it compares the demand price for existing capital goods with their supply price, as given by the costs of corresponding new investments.

The central idea of this valuation measure is that a high Q ratio creates a strong incentive to invest in the expansion of capacity by indicating that new plants could be built from scratch for less than what is paid for existing plants. Presently in America, market prices of companies are at their highest level in history relative to replacement costs, yielding a Q ratio of 170%. Yet economic behavior defies the logic of the model, as companies continue to stampede into grossly overpriced acquisitions rather than into cheaper new investment.

We have been wondering for some time about the true motivation behind this mergers-and-acquisition mania. It simply defies normal economic and financial logic. In the takeover craze of the 1960s, acquiring companies made use of their own inflated stock to buy companies with lower price-earnings ratios, thus creating illusory earnings growth. In the 1970s and 80s, when Q Ratios hovered between 40% and 60%, undervalued assets were the bait. In this light, both the takeover mania of the 1960s as well as the highly leveraged LBO mania of the 1980s made economic sense, at least for the individual players. The obvious, chief aim of the present merger mania are cost savings as the surest and easiest way to lift stock prices.

IF WALL STREET CRASHES . . .

Like everyone else, we struggle with the question: How big are the risks in the global stock markets? Economic conditions obviously differ between countries. But when it comes to stock markets, the place to look is Wall Street. World markets are closely linked to Wall Street by a web of psychological and liquidity channels. If Wall Street crashes, the others will crash as well. There may be differences in degree, yet overall trends are closely correlated.

In contrast to widespread market opinion, we always have doubted the likelihood of impending rate hikes from the Fed. Mr. Greenspan is playing a confidence game – constantly professing to be an inflation hawk when in fact money couldn't be looser. He knows better than Wall Street how vulnerable the economy and the financial markets are. Ironically, his own monetary laxness chiefly has generated this vulnerability.

In the complacent consensus view, there can't be a crash without drastic monetary tightening. But for us, 1929 is the relevant precedent. Presently, we see two major forces driving the U.S. stock market toward an eventual crash. One is the rapidly deteriorating profits picture. The other is the liquidity crisis essentially inherent in a heavily hyped and leveraged market. We always have warned of the inevitable, eventual crash, but have insisted that its timing escapes early prediction.

What primarily has alerted us to the mounting danger, though, is our analysis of the sources of the profits binge of 1992-94. It truly was exceptional, not only in size but also in its origin – sliding interest rates. The stock market, hyped by Wall Street propaganda, mistakenly discounted this transitory profits mirage as a new long-term trend, one that would extend far into the future. In this light, the puncturing of grossly elevated profit expectations is the primary cause of the sudden plunge of share prices. We can only warn: This is not an aberration; it is real.

THE COMING SCRAMBLE FOR LIQUIDITY

In past letters, we repeatedly have denounced as a mirage the Wall Street notion that this great bull stock market primarily has been liquidity-driven. By definition, this would imply money growth in excess of asset and GDP growth. In reality, ~~precisely the~~ opposite has happened. Between 1990 and 1995, the broad money stock ~~(M3)~~ dropped from 72% to 63% of GDP. What truly drove the markets was a collapse in the *demand* for liquidity ~~associated with a cumulative rise in~~ the money turnover for the purchase of financial assets – ~~that is~~, in the velocity

of money. The safest thing to say about such a mass flight out of liquidity is that it is bound one day to end in a desperate scramble to replenish liquidity by selling securities.

While alarmed by the public's unprecedented infatuation with stock speculation, we worry equally about the dangers lurking behind the scenes in today's world of financial engineering and derivatives proliferation. While we admit that we know little about the intricacies of derivatives and do not have the quantitative data to define the extent of their influence, it is exactly this obscurity that causes us such concern.

What we do know is that there has been tremendous growth in the number of financial institutions using sophisticated leveraging and hedging strategies, and that there currently is a preponderance of derivatives usage throughout the financial industry. We also know that the creation and marketing of derivative products has become a huge and booming business for Wall Street. The true extent of the leverage these instruments provide will not be understood until a bear market forces their liquidation.

We believe the stock market's behavior over the past several months shows a remarkable resemblance to the credit-market meltdown in the fall of 1993 and the subsequent prolonged decline in bond prices, which led to devastating bear markets in Treasuries, mortgage-backed securities, Eurodollars, and emerging markets, culminating in the Orange County and Mexico debacles. As during the frenzied boom that preceded the bond-market collapse, we fear that significant underlying risk has gone unrecognized in the stock market.

Now, as then, we have little doubt the futures and options markets lead and certainly dictate activity in cash securities. Furthermore, we expect that many market players will use derivatives in falling markets as insurance protection and to mitigate the general illiquidity of most stocks.

This clearly is a dangerous situation. We would consider the recent weakness in Microsoft and Intel, despite the fact that both companies recently reported better-than-expected earnings, as evidence of derivative-related selling.

Further market weakness could prove highly challenging to Wall Street operators attempting to dynamically hedge themselves with the plethora of derivative products they have created. Remembering the bond market's experience in 1994, we fear that the resulting selling could be both massive and self-reinforcing.

NEW DOLLAR DOLDRUMS

Once more, the dollar has defied the customary bullish forecasts. Given the prospect of higher U.S. short-term interest rates versus rock-bottom rates in Japan and the prospect of further declines in the already low hard-currency rates in Europe, it seemed an absolutely safe bet that the U.S. currency would rise at least until year's end.

We, too, envisioned a modest dollar rise. But as we noted in our May issue, we have remained intensely skeptical of the bullish consensus. In the absence of massive central bank intervention, we warned, the dollar's weakening trend could be expected to resume. This, by all appearances, is exactly what has happened.

What the perennial dollar bulls fail to understand is that the $150 billion U.S. current-account deficit simply is far too large to be financed by private foreign investors. But what makes the situation completely hopeless are equally chronic, massive U.S. capital outflows. In the first quarter of this year, foreign central banks bought some $55 billion in U.S. Treasury paper, vastly overfinancing the current deficit. But those purchases have fallen off sharply in recent months, while the U.S. trade deficit, as noted above, has exploded.

Absent a return to massive foreign central bank support, the dollar is sure to resume its downward course. Yet the inevitable consequence of any new foreign bailout is that U.S. interest rates and bond yields would remain depressed far below the equilibrium levels dictated by the miserable U.S. savings rate. This, in turn, only would

perpetuate the debt-financed growth of U.S. consumption, adding to the trade deficit. Ultimately, only progressively higher foreign official dollar purchases can ward off a dollar collapse.

But increasingly, we worry about a more immediate threat to the greenback. If the dollar has been so weak in recent years in the face of booming U.S. financial markets, what will happen to it when the U.S. stock market slides or crashes? Our analysis leaves us no doubt that such a crash is in the making.

CONCLUSIONS

U.S. bonds have taken a heavy beating, but the catalyst that dramatically has transformed unmitigated bullishness into bearishness toward stocks has been a string of negative earnings surprises.

The important negative to see is that the profits boom of 1992-94 that helped drive this bull market higher and higher had its ephemeral main source in sliding corporate interest-rate expenditures. As this windfall gain now has exhausted itself, profit growth is collapsing. Beware of disastrous profits reports later this year and in 1997, when a weakening economy will depress earnings even further.

Given also a progressive deterioration in liquidity, the conditions for a major decline in U.S. stocks, if not a crash, are in place. Any Wall Street rout tends to cascade into global stock markets.

While the disappointments in the technology sector get all the attention, it is worth noting that in the face of heavy equity selling, the bond also remains weak. All around, the markets are losing liquidity. This just demonstrates a fundamental truth about the collapse of any bubble: Falling markets don't release liquidity; they destroy it.

The real story in the falling equity market is the fact that even some of the big "safe haven" stocks have acted poorly – even after positive earnings surprises. This is directly related to the lack of liquidity in many, if not most Nasdaq stocks. The only way mutual-fund managers owning these small-cap stocks can cut exposure and raise cash is to sell the large names, often through derivatives transactions.

The other big casualty of recent weeks is the clobbered dollar. While Wall Street's woes may have acted as a catalyst, there are two deeper reasons for the greenback's distress: the soaring U.S. trade deficit, and the unwinding of vast bull positions built up since early this year. It looks like a new, unfolding dollar crisis.

Both the Bundesbank's refusal to lower its repo rate and the weak dollar have upset the "convergence game" in the European bond markets, hitting the high-yielding bonds and currencies.

THE RICHEBÄCHER LETTER

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